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DEPT FOR EAP/IET AND EB/IFD/OMA
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 DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR FINEMAN

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SUBJECT: PARLIAMENT PASSES 2007 BUDGET

11. (SBU) Summary. Parliament approved a Rp 763.6 trillion (USD 83.4 billion) FY 2007 budget on October 17. Spending for personnel, materials and social programs is slated to rise significantly in 2007 in line with President Yudhoyono's plans to reform the civil service and improve health and education standards in the country. Spending on fuel and electricity subsidies is set to decline slightly in 2007, but continues to account for 17 percent of central government expenditures. The Government of Indonesia (GOI) expects a significant increase in tax receipts in 2007, as illustrated by the projected 20% increase in tax receipts. Despite the spending increases, Indonesia's fiscal policy remains tight, with a projected deficit of 1.1% of GDP, down from the 1.3% of GDP target for FY 2006. The GOI's 2007 financing plan includes an anticipated Rp 3.3 trillion in privatization receipts, Rp 1.3 trillion of which the GOI will plow back into "equity injections" in state-owned enterprises. For the second year in a row, the budget also contains a Rp 2 trillion (\$218 million) financing line item to support the GOI's infrastructure development program. This report uses the October 17 market exchange rate of Rp 9,155/USD for all conversions. End Summary.

12. Parliament completed work on the GOI's 2007 budget on October 17. Table 1 outlines the major revenue, expenditure, and financing items in the budget. The Ministry of Finance has not yet finalized detailed spending allocations for individual programs.

 Table 1: FY 2007 and FY 2006 Budgets

Items (1)	FY 2006		FY 2007	
	Rp Trill	% of GDP	Rp Trill	% of GDP
<u>1</u> A. Total revenue	659.1	21.1	723.1	20.5
<u>1</u> I. Domestic revenues	654.9	21.0	720.4	20.4
Tax revenues	425.0	13.6	509.5	14.4
Domestic taxes	410.2	13.2	494.6	14.0
Income tax	213.7	6.9	261.7	7.4
<u>1</u> 1. Oil and gas	38.7	1.2	41.2	1.2
<u>1</u> 2. Non oil/gas	175.0	5.6	220.5	6.2
Value added tax	132.9	4.3	161.0	4.6
Land/bldg tax	18.1	0.6	21.3	0.6
Duties on land/ building transfer	4.4	0.1	5.4	0.2
Excise tax	38.5	1.2	42.0	1.2

Other taxes	2.6	0.1	3.2	0.1
Int. trade tax	14.8	0.5	14.9	0.4
Non-tax revenues	229.8	7.4	210.9	6.0
Natural resources	165.7	5.3	146.3	4.1
SOE profits	22.3	0.7	19.1	0.5
Other	41.8	1.3	45.6	1.3
II. Grants	4.2	0.1	2.7	0.1
B. Expenditures	699.1	22.4	763.6	21.6
Central govt. exp.	478.2	15.3	504.8	14.3
Routine	135.3	4.3	170.4	4.8
-Personnel	79.2	2.5	98.5	2.8
-Material exp.	56.1	1.8	71.9	2.0
Capital exp.	69.5	2.2	76.9	2.2
Interest payments	82.5	2.6	85.1	2.4
Subsidies	107.6	3.5	102.9	2.9
Social assistance	41.0	1.3	50.7	1.4
Other current exp.	42.3	1.4	18.8	0.5
Transfer to regions	220.8	7.1	258.8	7.3

Primary balance	42.5	1.4	44.6	1.3

Overall balance	(40.0)	(1.3)	(40.5)	(1.1)

Financing	40.0	1.3	40.5	1.1
Domestic financing	55.3	1.8	55.1	1.6
Domestic banks	17.9	0.6	13.0	0.4
Privatization (net)	1.0	0.1	2.0	0.1
Asset restructuring	2.6	0.1	1.0	0.0

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Govt Bonds	35.8	1.1	40.6	1.1
Infrastructure Fund	(2.0)	(0.1)	(2.0)	(0.1)
Foreign financing (net)	(15.3)	(0.5)	(14.5)	(0.4)
Gross drawing	37.5	1.2	40.3	1.1
Program loan	12.1	0.4	16.3	0.5
Project loan	25.5	0.8	24.0	0.7
Amortization of foreign debt	(52.8)	(1.7)	(54.8)	(1.6)

(1) Column totals may not add perfectly due to rounding.

Expenditure Highlights

13. Key spending highlights of the budget include:

--The GOI significantly increased routine spending on personnel and material expenditures. Personnel spending will increase 24% in nominal terms over 2006 and includes a 15% increase in base salaries and retirement benefits for the civil service, the military, and the police; an increase in teacher allowances; and a 20% increase in official per diem for the police and the army.

--Fuel and electricity subsidies, although smaller than in 2006, remain significant at Rp 61.9 trillion (\$6.8 billion) and Rp 25.8 trillion (\$2.8 billion), respectively. The high level of fuel subsidies continues to impede government spending on capital investment. Capital expenditures (formerly classified as development expenditures) increase by only 11% in nominal terms over 2006 levels to Rp 76.9 trillion (\$8.4 billion).

--The GOI will channel the bulk of 2007 social expenditures through line ministries via several social assistance programs. These include direct subsidies for education and health programs, funding for the "national community building program", and a Rp 2.8 trillion (\$306 million) conditional cash subsidy program. The conditional cash subsidy represents an extension of the Rp 15.6 trillion

(\$1.7 billion) cash subsidy program the GOI introduced in 2006 to ameliorate the impact of the October 2005 fuel price hikes. The social assistance line item also include a Rp 2 trillion (\$ 218 million) emergency reserve and disaster mitigation fund.

--Other expenditures drop by 56% compared to 2006, mainly due to the GOI's reclassification of the direct cash subsidy program.

--Transfers to regions increases by a nominal 17% over the previous year in the 2007 budget to Rp 258.8 trillion (\$28.3 billion), or 7.3% of GDP. The increase includes a 10.4% increase in natural resources revenue sharing funds (Revenue Sharing Fund or DBH) to Rp 68.5 trillion (\$7.5 billion), and a 13% increase in the General Allocation Fund (DAU) to Rp 164.8 trillion (\$18 billion). As in previous years, no region will receive less than last year; however, 2007 will be the last year that the DAU will increase consistently for all regions. Starting 2008, the GOI intends to share funds more equitably across regions, requiring resource-rich regions to "transfer their surplus" to under-resourced regions.

--In line with President Yudhoyono's policy to increase spending on social development, the Ministry of Education (MOE) receives the ministry highest budget allocation at Rp 43.5 trillion (\$ 4.7 billion), or 9% of central government spending. Further, the GOI has allocated an additional Rp 1.8 trillion (\$197 million) for nationwide education assistance programs, to be managed jointly by MOE and Ministry of Religious Affairs. The amount of funds allocated to the Ministry of Health increases by 20% compared to the previous year, rising to Rp 17.1 trillion (\$1.9 billion). The GOI allotted a portion of the increase to rural health clinics and local hospitals.

14. Table 2 lists the allocations for the ten agencies that receive the largest budgets 2007. The allocation for all major agencies increased, with the exception of the Aceh Rehabilitation and Reconstruction Agency (BRR).

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Table 2: FY 07 Budget Allocation By Ministries/
Agencies (in trillions of Rupiah)

Ministries/ Agencies	2006 Budget	2007 Budget	% Increase
Education	39.5	43.5	10.1
Defense	27.0	31.3	15.9
Public Works	18.3	24.2	32.2
National Police	16.0	19.0	18.8
Health	14.2	17.1	20.4
Religious Affairs	10.6	13.0	22.6
Transportation	8.0	10.4	30.0
BRR (1)	11.5	10.0	-13.0
Finance	6.6	9.4	42.4
Agriculture	6.2	8.7	40.3

(1) Aceh Rehabilitation and Reconstruction Agency

Revenue and Financing Highlights

15. The 2007 budget projects a 10% nominal increase in revenue over 2006 levels to Rp 723.1 trillion (\$79.0 billion). The increase is predicated on higher tax receipts, which are expected to increase by 20% in nominal terms to Rp 509.5 trillion (\$55.6 billion) or 14% of 2007 GDP. Tax revenue accounts for approximately 70% of total domestic revenue in the 2007 budget. On the other hand, the GOI expects lower revenues from natural resource sources, with natural resource tax and non-tax revenues falling from

Rp 198.5 trillion (\$21.7 billion) in 2006 to Rp 181.1 trillion (\$19.8) in 2007. Table 3 summarizes revenues for FY 2007.

¶6. The projected 2007 budget deficit is Rp 40.5 trillion (\$4.4 billion), equivalent to 1.1% of GDP. Notably, the 2007 projected deficit to GDP ratio is lower than in 2006, despite calls for increased government spending to spur growth. The GOI will finance the deficit through a combination of domestic and foreign bond issuance. The MOF has not announced a financing plan for 2007, but in 2006 the GOI financed a deficit of a similar magnitude with an approximately 50/50 mix of rupiah and dollar bonds. The budget also signals the resumption of a limited privatization program with a Rp 3.3 trillion (\$360 million) line item for gross privatization proceeds, Rp 1.3 trillion (\$142 million) of which is netted out in the form of "capital injections" into several state-owned enterprises. For the second year in a row, the budget also contains a Rp 2 trillion (\$218 million) infrastructure funding line item. The GOI plans to use these funds to establish a revolving fund for land acquisition and a contingency fund to cover the cost of GOI guarantees for infrastructure projects. Table 4 provides breakdowns on budget financing sources.

Table 3: FY 07 Financing
(in trillions of Rupiah)

Items	2006 Budget	2007 Budget
Primary balance	42.5	44.6
Deficit	(0 .0)	(40.5)
Financing	40.0	40.5
-- Domestic (net)	55.3	55.1
- Bank financing	17.9	13.0
Privatization	1.0	2.0
- Asset restructuring	2.6	1.5
- Govt bonds (net)	35.8	40.6
- Infrastructure Fund	(2.0)	(2.0)
-- Foreign loans (net)	(15.3)	(14.5)

Mostly Credible Budget Assumptions

¶7. Table 4 outlines the economic assumptions underlying the FY 2007 budget. The assumptions are important because they influence various revenue, spending, and financing items in the budget. For example, if the GOI adjusts the USD/Rp

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assumption upward, the value of Indonesia's USD oil exports calculated in rupiah rises, while the rupiah value of Indonesia's USD debt service also rises. Most observers regard the assumptions as credible, with the possible exception of the projected 6.3% real GDP growth rate in 2007, which is on the high side of many economists' forecasts.

Table 4: FY 2007 Budget Assumptions

	2006 Budget	2007 Budget
Real GDP growth (1)	5.8	6.3
CPI inflation	8.0	6.5
USD/IDR (avg)	9,300	9,300
3-month SBI rate (avg)	12.0	8.5
Budget deficit (2)	1.3	1.1
Average oil price (3)	64	63
Oil production (4)	1,000	1,000

(1) Percent.

(2) As a percent of GDP

(3) Indonesia Crude Price (ICP) in US\$ per barrel

(4) In million barrels per day

PASCOE